1961

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William J. Planthaber

Recommended Citation
Haskins & Sells Selected Papers, 1961, p. 215-225

Fraud and Internal Control

by WILLIAM J. PLANTHABER
Partner, Houston Office

Presented before the Texas Chapter of the National Office Management Association, Beaumont, Texas—October 1961

KNOWLEDGE of fraud and of factors important to its prevention is mandatory if men, such as you, who are a part of management are to carry out their functions capably.

Fraud and embezzlements are nothing new on the American business scene. An introduction to a text on the subject, published over thirty years ago, stressed the alarming prevalence of fraud as one of the great problems confronting business. Today the emphasis is on its alarming growth.

The American Bankers Association reports bank embezzlements of more than $10,000 each for the calendar years 1958, 1959, and 1960 to be $6,400,000, $8,800,000, and $10,100,000, respectively. During the first half of 1961, a record annual rate of $17,000,000 was being established. A decade ago, in 1951, the figure was $5,600,000. While these figures represent a substantial 300 per cent increase in one decade, they are, in the words of one banker, microscopic when compared with industrial pilferage and business embezzlements.

New business development in the consumer financing field has, in recent years, added to banks' vulnerability. This is a highly specialized field of activity and requires especially good controls over loan approvals and pay-outs, and credit and collection procedures. It is always a suspicious circumstance to auditors when only one person in a finance company or consumers' credit department of a bank has handled all activities relating to a borrower's account. As a group, however, banks have done much to control embezzlements. This includes not only the work of bank-audit committees and more activity in independent verification of customers accounts, but additional assurance by engaging the services of certified public accountants as well.

There are no accurate statistics on the annual embezzlement loss to business. Some authorities say a million businessmen are victimized by embezzlers every year, and that annual embezzlement losses range from one to three billion dollars. If the annual losses are only one-half the maximum estimate, the daily losses are $5 million per working day. That business embezzlements are keeping pace with the rise being experienced by banks is demonstrated by an increase of 250 per cent in fidelity insurance losses from 1946 to 1956.

In commenting on bank-embezzlement losses in September of this year, Mr. George H. Hottendorf, deputy manager of the American Bankers Association, stated, "When considering the upward turn in bank embezzlement losses, it should be realized that there has been a huge increase in the number of people working in banks, in the amount of assets banks handle, and in over-all dollars-and-cents activity in banks." In the last decade, the total assets of banks have mounted from $194 to $303 billion dollars. The number of people working in banks has increased from 439,000 to 685,000, and velocity —the rate at which the money supply moves through the banking system—has increased by more than 20 per cent. Mr. Hottendorf said that on a per capita basis embezzlements in banks were decreasing substantially from year to year.

Expansion in American business since World War II in terms of total assets, operations, and personnel, is undoubtedly an important factor in rising business-embezzlement losses as well as in banks, but this is not the only theory. Decentralization of responsibility and geographical dispersion of operations have been cited as making it easier for dishonest employees, because when a business is far-flung there is less home-office scrutiny, and only periodic rather than daily checks on activities. Undoubtedly more important is an apparent decline in American morality, as is amply shown by revelations of payola, price-fixing, kickbacks, bribes, industrial espionage, misleading advertising, expense-account abuses, and income tax evasion. In the latter area alone, over one and one-half billion dollars in penalties, interest, and back taxes have been paid to the Internal Revenue Service for the year 1957 alone, although in all fairness, it must be admitted that a substantial portion of this amount relates to honest differences of opinion.

In analyzing the maze of available facts, statistics, and opinions on this subject of fraud, one truly alarming question keeps rising to the surface: "How many undiscovered embezzlements are there in business today, where are they, and what can be done about them?" There is, of course, no answer to the first two parts of this question, although one group of bankers estimates that undiscovered bank losses total $10 to $25 million. Undiscovered embezzlements in business must, then, be enormous both in number and in amount. As to what can be done about it, the answer is, in my opinion, to review existing preventive measures to obtain assurance that the best possible job is being done. In many businesses there is much that can be done in the areas of personnel selection and practices and improving the internal control.

First, let's take a look at the embezzler. One study of over 1,000 embezzlers revealed this composite picture of the average male embezzler. He is thirty-five, married, and has one or two children. He lives in a respectable neighborhood, drives a medium-priced car, and is often a church officer. He has been employed by his firm for three years and he has been stealing for eight months. On the average his total take exceeds his annual salary by twenty per cent.

The foregoing composite picture is, of course, a blending of tremendous extremes, and does not cover women who, it has been found, are just as dishonest as men if they are given the opportunity. Very often though, and this is something we should never forget, the embezzler is the last person anyone would believe capable of committing fraud.

An indication of the extremes blended into the composite picture of the average male embezzler is found in the table, "Arrests by Age Groups for Embezzlement and Fraud" in the Federal Bureau of Investigation's *Uniform Crime Reports for the United States.* Of 32,600 arrests in 1960, the greatest number, 5,834, were in the 30-34 age group. However, there also were 212 under age 15; 2,755 over age 50; and substantial numbers in every age group in between.

Analysis of positions held by embezzlers indicates that no position is immune. In the study of over 1,000 embezzlers referred to above, over 37 per cent held executive or managerial positions, with most, over 47 per cent, coming from the ranks of sales and clerical personnel.

The reasons for embezzlement are probably best left to a psychiatrist. They are as many and varied as their methods. It is not uncommon to find the reason in the modern behavior that follows an ancient pattern—gambling, extravagant living, and excessive drinking. Medical expenses, support of parents or other relatives, expensive hobbies, and just plain better living are often motives. One unusual case concerns an embezzler who decided he needed an income of $4,500 to live decently, while his actual salary was only $2,500. He proceeded to steal the difference. As the years went by and his salary increased, he reduced his thefts proportionately. When he finally began to make

$4,500 a year legitimately, he stopped stealing. Then, as his salary continued to rise, he reversed the process and began restoring the difference between what he was actually making and the predetermined amount of $4,500. When the loss was discovered, he had repaid all but $3,000 of a total of $25,000.

As long as we are dealing with people, the risk of losses from thefts will be present. Many businessmen though, seem to accept this as an inevitable business risk and fail to take safeguards to prevent it. In the area of employment practices, the first rule should be to get the right man for the right job. It is well to remember that an employee who, with or without reason, feels that he is underrated or underpaid, can become a dissatisfied employee and a potential embezzler if given the opportunity.

Secondly, references should be thoroughly checked and former employers consulted. For a variety of reasons, embezzlers are often not prosecuted, and accordingly are free to go from job to job unhindered. Several cases, one quite recently, have come to my attention where considerable embarrassment and financial loss could have been precluded if the advice of references and former employers had been sought. It is not a bad idea either, to look into the credit rating of prospective employees.

Some items of personnel policy that should not be overlooked include a good training program, a mandatory vacation policy, job rotation, and periodic employee-evaluation reports. Not to be overlooked are reasons for consistent, and apparently diligent night and week-end work, and the living standards and outside activities of employees in positions of trust. We should not forget that Minnie Mangum, who embezzled $3 million over a 23-year period from a Norfolk building and loan association was one who never took a vacation, and even worked week ends and holidays to "get her records in order."

An excellent example of management's ignoring a danger signal for some time is the case, reported in *Fortune Magazine,* of Roscoe David Coon, Sr., who—between January 1950, and July 1955—embezzled $678,000 from the Joshua Monument National Bank of Twenty-nine Palms, California. When Coon went to work for the bank as vice president and cashier at a salary of $400 a month on May 1, 1949, his worldly possessions consisted of an equity in a small house, its furnishings, his personal effects, and two 1937-model automobiles. When Coon was apprehended by Federal agents at the

Del Mar track on July 25, 1955 (the same day the bank closed for good), his financial status had changed considerably. He had purchased at least thirty-six thoroughbred race horses, which he had raced at six California tracks, the Las Vegas track, and in Mexico. One horse was bought by Coon in Kentucky for $53,500; another he got in New Jersey for $60,000. He had built at least seven houses in the Twenty-nine Palms area, had engaged in turkey ranching and gold mining, had made investments in a finance company, a lumber company, and a night club and bar. During the same period Coon had made a number of loans to people in Twenty-nine Palms, including customers who had been refused loans by the bank, fellow employees, two bank directors—and the bank president.

As one insurance executive phrased it, the philosophy that the world owes me a living is now being replaced by the world owes me a *high* living.

Internal control is described by the American Institute of Certified Public Accountants as *the plan of organization and all of the coordinate methods and procedures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.*

With respect to internal control, the principal responsibility of the independent certified public accountant in connection with an examination of financial statements is to study and evaluate the existing internal control as a basis for reliance thereon and for the determination of the extent of audit tests. Establishing and maintaining the internal control are entirely within management's jurisdiction and, therefore, the accompanying responsibility rests with management.

The possible existence of fraud is of paramount concern to every practicing independent accountant. Nevertheless, where the objective of the independent accountant is formulation of an opinion respecting the fair presentation of the financial statements, the discovery of fraud is no more than incidental. Whether errors are intentional or unintentional, their materiality is of major concern to the accountant. Often, seemingly large errors escape our attention because, in view of their immateriality with respect to the financial statements taken as a whole, auditing procedures may not be designed to find them. Also, published accounts of defalcations almost always give prominence to the cumulative amount concerned although the annual components may be inconsequential considering the size of the company.

Very often your independent certified public accountant will, in the course of his examination, detect areas in which the internal control and accounting procedures might be improved. Management should avail itself of his detached viewpoint, and request that he convey his thoughts to management either orally or in writing. Ideas, suggestions, and recommendations concerning the internal-control accounting procedures and other accounting matters are a natural result of the work of the independent accountant, who frequently is more intimately familiar with procedures and routines on completion of an examination than is the management.

While some studies have indicated that accident, rather than auditing or good internal control, is responsible for discovering a large percentage of embezzlements, it should not be overlooked that auditing and good internal control, including internal auditing, do result in discovering a large number, and more importantly, in precluding many more. No prudent management will discount the value of auditing or good internal control in this area.

The following few examples are typical of how embezzlements are discovered. They are taken from a study of over one hundred cases.

- The irregularity was discovered in the process of preparing the year-end financial statements. The company's accountant noted that the gross profit ratio was significantly distorted.
- The irregularity was discovered by an employee who observed that certain sales were not being recorded on the cash register.
- Investigation of accounts receivable confirmation exceptions during the course of an audit revealed the irregularities.
- In a small-loan company, while testing loan cards to the trial balance of outstanding loans, the independent auditor noticed that he had not been given cards for the oldest balances.
- Again in a small-loan company, the irregularity was discovered during an unannounced visit by the supervisor of the loan office.
- The defalcation was discovered by the company's office manager reviewing the monthly financial statements. He noticed a large increase in the amount of accounts receivable and decided to send out letters in an effort to increase collections. Exceptions to amounts shown in the letters revealed the defalcation.

- The records eventually became so numerous and the related bookkeeping so complex that errors were made by the credit manager which brought the shortage to the attention of one of the firm's partners.
- Because of laxness on the part of the warehouse manager, the company decided to dismiss him. In accordance with established company practice, a complete physical inventory was taken at the time the manager was relieved. The inventory shortage was discovered at this time.
- The petty cash shortage was discovered when two employees took over the cashier's duties while he was ill. A count of cash by the employees revealed the shortage in the fund.

Several lessons can be drawn from the foregoing cases, particularly where there is an indication of lack of proper controls or, on the other hand, where the defalcation was discovered by an alert employee who paid particular attention to detail.

The components of a good system of internal control differ from company to company. The size of the company, the nature of the operations, and the number and type of locations concerned must be considered. Here is a list of some controls that will, in most cases, apply regardless of the size of the company, in addition to the matter of personnel selection and training already referred to:

- The organization should be clearly defined, and formalized by use of an organization chart or its equivalent, setting forth responsibilities of management personnel.
- Expenditures should be controlled through the use of a budget system, preferably administered by a person independent of the ones responsible for the expenditures. The company should plan and forecast its objectives and there should be a follow-up of deviations from budgeted amounts.
- Consistency of account classification and reporting should be provided for by use of a chart of accounts.
- There should be a division of duties, to the extent practicable, to preclude the concealment of irregularities singlehandedly, and the existence of important unintentional errors in the records.
- Useful periodic financial and statistical reports should be prepared for submission to the management on a timely basis.

• There should be adequate follow-up to determine that prescribed procedures are being observed.

In addition to the foregoing procedures, which have general applicability, there are many additional features of control concerning the routine in the various areas of activity which must be tailored to the nature and size of the business. These relate to the handling of cash receipts, cash disbursements, sales, receivables, purchases, payrolls, inventories, property, securities and the like. Studies of actual cases indicate the incidence of fraud and embezzlement is exceptionally high, both in number of cases and in dollar amount concerned, in the areas of cash receipts and disbursements. In one study it was found that cash receipts accounted for over 50 per cent of the number of cases, but only 16 per cent of the amount concerned. Cash disbursements accounted for over 40 per cent of the number of cases, and 80 per cent of the amount concerned. The conclusion can be drawn that businesses are especially vulnerable, first, in cash-disbursement procedures and, secondly, in cash-receipts procedures. I would like, therefore, to review some of the procedures deemed essential to good internal control in these areas.

As to cash disbursements, first, the supply of blank checks should be safeguarded, and preferably they should be numbered and all numbers accounted for. Use of a check protector is desirable, and protected paper should be used. One case that has come to my attention may be of interest. On converting preparation of payrolls and payroll checks from an old machine to a newer one, requiring a new form of check, someone in the accounting department assumed responsibility for disposing of the old supply of checks without mutilating them. The checks fell into the hands of an unauthorized person who started using them. His activities covered a wide area in several southern states. It took six months for the FBI to catch up with him, and caused the company considerable embarrassment.

It is preferable that the employee who prepares checks should not have authority to sign the checks singly or to reconcile the bank account. All checks should, of course, be prepared from approved disbursement vouchers or check requisitions and the procedure should assure payment of invoices within discount periods. If the checks are signed mechanically the use of the machine and signature plate should be properly controlled. All checks should be accompanied by approved disbursement vouchers or check requisitions when presented for signature and the supporting documents should be canceled to prevent their being used again. Finally, the checks should be safeguarded against interception by unauthorized personnel prior to being mailed, and should never be returned to the person initiating a request for payment, for delivery to the payee by hand.

Bank accounts should be reconciled each month promptly on receipt of the statements and canceled checks from the bank. The procedure should provide for comparison of details of checks with entries in the cash disbursements record, examination of signatures and endorsements, accounting for the sequence of check numbers and follow-up of old outstanding checks. Improperly endorsed checks preferably should be returned to the bank with instructions to obtain proper endorsements.

Disbursements from petty cash funds should be reviewed and checked at the time they are vouchered for reimbursement, and the supporting tickets and invoices should be canceled to prevent their being used again. Petty cash tickets should be prepared in ink, in such a manner as to preclude their being raised or otherwise altered and, of course, should be approved. All disbursements from petty cash funds should be processed for reimbursement, including loans to employees, travel advances and the like. They should not be carried in the fund for an indefinite period. It is preferable that petty cash funds be on an imprest basis, and responsibility for their custody should be definitely fixed. The amounts of such funds should be reviewed periodically to determine that they are adequate, but not excessive in the circumstances.

With respect to cash receipts, mail receipts should be controlled to prevent abstraction before entry in the cash-receipts record and should be handled by as few persons as possible between the time of receipt and the time of deposit. One unusual case relates to an incoming receipt of very substantial amount, almost $200,000. The check was intercepted by an unauthorized person, who typed his own name above the name of the payee, and the name of the city and state below the name of the payee, so that the name of the legitimate payee appeared to be part of an address. He then opened a bank account and deposited the check. This irregularity was found because bank officials noticed the unusual amount of the check, refused to honor checks drawn on the account, and brought the matter to the attention of the company. This case should, however, serve to emphasize the need for tight control in handling cash receipts. Incoming receipts should be deposited in the bank intact and not be commingled with other cash or used for making disbursements or cashing checks. All receipts should be deposited in the bank as promptly as possible. Finally, persons who handle cash receipts should not have access to other cash, such as cash on deposit, and funds not carried on the books of the company, nor should they have custody of securities.

These are but a few of the procedures that should be considered for the handling of cash receipts and disbursements. I would like to repeat that they are not all-inclusive or universally applicable. In many cases the nature of the business requires special routines, such as in the case of retail routes, loan-office operations, and retail stores.

Closely related to internal control is the area of physical control of assets, sometimes termed industrial security. Industrial pilferage usually includes larceny, which results from unlawful entry, as well as embezzlement, which refers generally to theft of property in an employee's custody. Some factors to be considered in physically safeguarding the assets of a company are plant location, plant layout, the use of armed uniformed guards, alarms and closed circuit television, and outside perimeter security. These security measures are important and should receive the careful attention of management. It should be realized, however, that mechanical devices can be tampered with and are not infallible.

Undoubtedly time, although not a tangible asset of the company, is one of the items most susceptible to theft. Coffee-break abuses, late arrivals and early departures, water-cooler conversations, and excessive use of powder-room privileges, are but a few examples. A time clock is often helpful in controlling time, but this too is not infallible. I have in mind a situation that existed in one New York concern where some of the secretaries learned that they could punch out for lunch, punch in from lunch, go shopping for the afternoon, and return at five to punch out again.

In concluding, I should like to stress, as has perhaps been apparent from some of the examples presented, that there is the usual as well as the unusual when we start looking for fraud and embezzlement. I firmly believe it is a matter that we all should have constantly in mind, but with the realization that with respect to the type of personality, motives, and method, we are looking for the unusual. One story, which you may have heard, has now become a classic and seems appropriate to demonstrate that the obvious should not be overlooked. It concerns the employee who approached the factory gate every night, pushing a wheelbarrow filled with sand. Each night the guard filtered out all the sand but could find nothing amiss. At the end of the month the guard could take it no more. "Look," he told the employee, "I know you're stealing something but for the life of me I can't figure it out; before I go crazy, please tell me what it is. I swear I won't turn you in." The employee winked and replied, "Why, wheelbarrows, of course."